Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:MCT:DET:TL-N-2427-00
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date:

to: Territory Manager, Retailers, Food & Pharmaceuticals, LM:RFP
Sarolta Ficsor, Team Manager
Attn: Larry Bayer, IE

from: LMSB Counsel, Detroit, Michigan

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subject: [redacted], FYE [redacted]
I.R.C. §§ 451, 862 - Recognition of Foreign Source Royalty Income

This memorandum is in response to your request for advice regarding [redacted]'s timing for recognition and character of royalty income received from [redacted] pursuant to a revised royalty agreement. The advice in this memorandum is subject to post-review in the National Office, which we will expedite. If you have any questions, please call the undersigned at (313) 237-6426.

DISCLOSURE STATEMENT

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Issues

I. Whether the discounted value of promissory notes [redacted] received from [redacted] in [redacted] is included in [redacted]'s income in that year.

II. If the promissory notes constitute income to [redacted] in [redacted] is such income U.S. sourced or foreign sourced for purposes of computing [redacted]'s foreign tax credit allowance.

Conclusions

I. The discounted value of promissory notes [redacted] received from [redacted] in [redacted] should be included in its income for that year.

II. The income recognized as a result of the promissory notes received during [redacted] is foreign sourced income pursuant to I.R.C. § 862.

Facts

[redacted] ("[redacted]") entered into an initial Trademark Licensing Agreement with [redacted] ([redacted])[1] on [redacted]. This agreement authorized [redacted] to manufacture and sell within Japan certain products upon which [redacted] owned trademark, tradename and manufacturing intangibles. The agreement detailed specific products and established a royalty rate based upon the volume of sales of those products within Japan. The actual royalty payment was due after [redacted] determined the sales of the covered products.

On [redacted], [redacted] and [redacted] amended the initial agreement titled "Amended and Restated Trademark Licensing Agreement" (attachment A)("the Amendment"). the Amendment called for [redacted] to issue "demand promissory notes" to [redacted] during [redacted]'s fiscal year ended [redacted], in an amount equal to an estimated royalty for the covered products for [redacted] and [redacted]. Pursuant to this agreement, [redacted] recognized income attributable to the promissory notes in FYE [redacted].[2]

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[1] [redacted] is a Japanese entity originally formed, and [redacted]% owned by [redacted]. During [redacted], [redacted]s stock was distributed to the [redacted] shareholders. After the distribution, approximately [redacted]% [redacted]'s stock was offered for sale to the public and [redacted] became a publicly traded company.

[2] The examination team adjusted [redacted]'s FYE [redacted] income tax return to deferring the income attributable to the promissory notes until the due dates of the respective notes. Appeals' subsequent resolution reflected [redacted]'s partial concession of the issue.

On [redacted], [redacted] entered into a "First Amendment to Amended and Restated Trademark License Agreement" (attachment B). This agreement provided that [redacted] would issue six negotiable promissory notes to [redacted] during [redacted]'s FYE [redacted]. The notes were in the amount of the estimated royalties due for FYE [redacted], [redacted] and [redacted]. Each note was respectively due and payable on the same date as the royalty payment would have been due under the original trademark agreement.

The agreement provided the estimated royalty payments would be calculated by estimating [redacted]'s total net sales of the covered products for the FYE [redacted] [redacted], and [redacted] (the royalty base) and then applying the [redacted]% royalty percentage to [redacted]% of the estimated royalty base. Additionally, [redacted] was obligated to pay a contingent royalty equal to the royalty rate, in the subsequent years, applied to the excess sales of the covered products during FYE [redacted], [redacted], and [redacted] which exceeded [redacted]% of the royalty base.

Thus, under the Amendment, [redacted] would receive a minimum royalty of [redacted]% applied to [redacted]% of the estimated royalty base. [redacted] would also receive an additional contingent royalty on [redacted]'s actual net sales of the covered products during FYE [redacted] through [redacted] if they exceeded [redacted]% of the estimated royalty base. [redacted] would receive no royalty payments for sales between [redacted]% and [redacted]% of the estimated royalty base.

[redacted] received the negotiable promissory notes in FYE [redacted] and included the discounted U.S. dollar value of the notes, $[redacted], as foreign source income. By accelerating its foreign source income for FYE [redacted], [redacted] was able to use foreign tax credits which would have otherwise expired in that year. [redacted] also received contingent royalties in FYE [redacted], [redacted], and [redacted], since the actual [redacted] sales of covered products during that year exceeded [redacted]% of the estimated royalty base. In response to various requests for information regarding the Amendment, [redacted] indicated that in addition to using the foreign tax credits, the agreement offered protection against fluctuations in [redacted]s sales of the covered products and gave it the option of factoring or discounting the negotiable promissory notes prior to the due date of the actual royalty payments. In essence, [redacted] claimed that the promissory notes converted its relationship with [redacted] from licensee/licensor to that of debtor/creditor, thereby giving [redacted] more flexibility in terms of assigning the notes.

Discussion and Analysis

Issue I. Income Recognition

The examination team proposes to adjust [redacted]s royalty income during FYE [redacted] and spread the income over [redacted], [redacted], and [redacted] the years during which the payments under the original trademark agreement would have been made by [redacted] The examination team has asked whether the economic substance doctrine would provide a basis for disregarding the Amendment or, if not, whether [redacted] correctly accelerated the FYE [redacted] through [redacted] royalty income into FYE [redacted] on the basis of the negotiable promissory notes received in [redacted].

The examination team has also asked that if [redacted] correctly included the royalty income in FYE [redacted], whether the issuance of the promissory notes alters the characterization of the royalty income as foreign sourced income pursuant to I.R.C. Section 862.

A. Economic Substance Doctrine

The economic substance doctrine may be applied to disregard the form of a transaction in favor of its substance for Federal income tax purposes where the form is inconsistent with its economic substance. Gregory v. Helvering, 239 U.S. 465 (1935). In examining the instances in which the economic substance doctrine should be applied, the Supreme Court opined in Frank Lyon Co. v. United States, 435 U.S. 561 (1978) that "a genuine multiple-party transaction with economic substance... compelled or encouraged by business or regulatory realities, ... imbued with tax-independent considerations, and ... not shaped solely by tax-avoidance features" should be respected for tax purposes.

In the present case, the Amendments effected two principal changes to [redacted] and [redacted]s relationship. First, it altered the way in which the royalty payment would be calculated. Rather than applying a fixed royalty percentage to [redacted]s actual sales of covered products in any given year, the agreement applied a fixed percentage to a portion of an agreed estimated royalty base.

Second, the Amendments required [redacted] to deliver six promissory notes to [redacted] in FYE [redacted], representing the future payment of the calculated royalty payments.

[redacted] argues that in applying the economic substance doctrine to the amended royalty agreement, the fact the agreement altered the legal relationship between the parties is enough to infer economic substance and considerations of business purpose or other nontax motivated considerations are unnecessary.[3] [redacted] cites Kraft v. Commissioner, 232 F.2d 118 (2d Cir, 1955) as its principal authority for this interpretation. However, that interpretation is untenable in light of the recent string of opinions which look beyond whether the form of the transaction merely altered the legal relationship of the parties. See ACM Partnership v. Commissioner, T.C. Memo. 1997-115, and Compaq v. Commissioner, 113 T.C. 17 (1999).

In Compaq v. Commissioner, 113 T.C. 17 (1999), the Court specifically noted that "To satisfy the business purpose requirement of the economic substance inquiry, 'the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and ... economic situation.'" Id. at 22, citing ACM Partnership v. Commissioner,157 F.3d 236.

In the present case it is important to note, for purposes of applying the economic substance doctrine, that the underlying royalty agreement establishing the licensor/licensee relationship between [redacted] and [redacted] had been in place since [redacted] and the economic substance of that relationship/agreement is not in question. At issue here is the change to the royalty agreement which provided the additional tax benefits by accelerating royalty income into [redacted] in order to use expiring foreign tax credits.

Having noted the differing views on the application of the economic substance doctrine in the present case, the facts indicate the amended royalty agreement possessed economic substance and a business purpose other than tax- avoidance considerations. Specifically, the agreement insulated [redacted] from the [redacted]s possible sales fluctuations during FYE [redacted] through [redacted]. In return, [redacted] received a discount in the amount of royalties paid based on the estimated royalty base. Additionally, [redacted]s delivery of the promissory notes provided [redacted] with the option of factoring or discounting the notes to third parties. Moreover, the Service has recognized the validity of transactions which accelerate income for services, royalties, rents, etc., and requires such prepaid income to be included in income in the year it is received. See Rev. Rul. 60-85, 1960-1 CB. Thus, the amended royalty transactions should not be disregarded for federal income tax purposes since they possess economic substance.

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[3]In response to a request for additional information from the examination team, [redacted] submitted a memorandum discussing the application of the economic loss doctrine to the amended royalty agreement. (See attachment C)

B. I.R.C. Section 451

I.R.C. Sec. 451. Provides in part that :

General rule for taxable year of inclusion.

> (a) General rule. The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

A taxpayer using the accrual method of accounting must include an item in gross income when all the events have occurred that fix the right to receive the income, and the amount of such income can be fixed with reasonable accuracy. Treas Reg. Sec. 1.451-1(a). It is well established that a taxpayer must include in income, for the year of receipt, the fair market value of a negotiable promissory note of a responsible and solvent maker. Scharf's Estate v. Commissioner, 316 F. 2d 625 (7th Cir. 1963), affg. 38 T.C. 15 (1962);and Barnsley v. Commissioner, 31 T.C. 1260 (1959).

In the present case, [redacted] received six negotiable promissory notes in FYE [redacted] Each note represented one-sixth of the total amount of the estimated minimum royalty payment due under the amended royalty agreement. The value of the notes was properly converted from yen to U.S. dollars and discounted to present value to determine the amount of income includible as income for FYE [redacted]. [redacted]s ability to satisfy the notes is not in dispute.

Thus, [redacted] properly included the discounted value of the notes as income in FYE [redacted].

Issue II. Character/Sourcing for the income realized by [redacted] upon receipt of the promissory notes

Generally, for international tax considerations, the source of royalty payments is determined by the place where the property (to which the royalty payment relates) is located or used. I.R.C. Section 862(a)(4). The intangibles giving rise to [redacted]'s obligation to pay royalties to [redacted] are located and used in Japan. Thus, it would appear the royalty payments should be foreign sourced income pursuant to I.R.C. Sec. 862(a)(4). The present case, however, presents a unique issue since the royalty income [redacted] recognized in [redacted] is not predicated on the receipt of actual royalty payments but rather receipt of negotiable instruments, the amounts of which were determined by reference to future royalty payment obligations.

In relevant part, the First Amendment to the Amended and Restated Trademark License Agreement provides as follows:

> 1. Exclusively for [redacted]s three (3) fiscal years ending [redacted], [redacted] and [redacted] (the "Amended Years") the parties agree that, to the extent described herein and subject to paragraph 2 hereof, Paragraphs 2(a) and 2(e) of the Amended Agreement shall not be enforced.[4] Instead, in lieu of certain license fees payable by [redacted] with respect to certain sales of certain products (as hereinafter described) for the Amended Years, [redacted] agrees to execute six negotiable promissory notes (herein so called) payable to [redacted] at six month intervals beginning [redacted], in the form of attached <u>Exhibit A</u>, each in the amount of [redacted] (¥[redacted]) and [redacted] agrees to accept the Promissory Note in satisfaction of such fees. ...

The provision above clearly shows the negotiable promissory notes were given "in lieu of" and "in satisfaction of" the estimated (and agreed) royalty payments due from [redacted] to [redacted] for [redacted], [redacted], and [redacted].

Pursuant to the origin of the claim doctrine set forth in <u>U.S. v. Gilmore</u>, 372 U.S. 39 (1963), the character or classification of payments for Federal income tax purposes may, in certain circumstances, be based on the underlying facts giving rise to the payment. The origin of claim doctrine has traditionally been used to characterize legal expenses for Federal income tax purposes by the origin of the claim litigated. <u>See</u> <u>Woodward v. Commissioner</u>, 397 U.S. 572 (1970). However, courts have extended the origin of claim doctrine to the characterization of Title VII damage recoveries, looking to the nature of the claimed injury as the basis for the taxability of the damage award (i.e., personal or economic); <u>see</u>, <u>e.g.</u>, <u>Roemer v. Commissioner</u>, 716 F.2d 693, 697 (9th Cir. 1983). In such cases, the payments may be characterized in accordance with the type of action or claims upon which the lawsuit was originally based. Applying this rationale to the present case, the promissory notes (and thus the related income [redacted] recognized in [redacted]) would be considered royalty income [redacted] received for [redacted]s use of the intangible property. As such, the note payments represent the payment of royalties and the income classified as foreign sourced income.

Given the negotiable nature of the promissory notes, [redacted] could have factored or discounted them to a third party in order to receive cash during [redacted][5]. Such a transaction, however, would not have altered the analysis above since conversion of the promissory

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[4] Those provisions set forth an original payment arrangement whereby [redacted] would pay [redacted] the calculated royalty payments semi-annually in [redacted] and [redacted].

[5] The audit team indicates [redacted] held the promissory notes until maturity.

notes to cash less a discount merely changes the form, i.e. from notes to cash, of payment not the substance of the underlying (royalty) transaction upon which the character of the income is based. Similarly, any third party redeeming such factored or discounted promissory notes from [redacted] at the maturity date would not recognize foreign source royalty income since the origin of the income (as analyzed by applying the same principles stated above) to the third party is the factoring/discounting transaction with [redacted].

If you have any further questions concerning this matter, please feel free to telephone the undersigned at (313) 237-6426

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By: ________________
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As stated